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In the Supreme Court of the United States

October Term, 1984

LOUISIANA PUBLIC SERVICE COMMISSION, THOMAS E. POWELL, GEORGE J. ACKEL, ED KENNON, LOUIS LAMBERT AND JOHN F. SCHWEGMANN,

Appellants

versus

SOUTH CENTRAL BELL TELEPHONE COMPANY,

Appellee

On Appeal from the United States Court of Appeals for the Fifth Circuit

APPENDIX TO JURISDICTIONAL STATEMENT VOL. II—APPENDIX A (Continued) — APPENDIX E

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A-57

Before the

Federal Communications Commission

Washington, D.C. 20554

CC Docket No. 79-105
RM-3017

In the Matter of

Amendment of Part 31, Uniform System of Accounts for Class A and Class B Telephone Companies, of the Commission's Rules and Regulations with respect to accounting for station connections, optional payment plan revenues and customer provided equipment and sale of terminal equipment.

Petition for Declaratory Ruling on Question of Federal Preemption Involving Order Of the Public Utilities Commission of Ohio in Conflict with (i) FCC Prescriptions Under Section 220 of the Communications Act and (ii) Established FCC Policies.

MEMORANDUM OPINION AND ORDER

Adopted: December 22, 1982 Released: January 6, 1983

BY THE COMMISSION: COMMISSIONER FOGARTY ISSUING A SEPARATE STATEMENT.

1. The Commission has before it a Petition for Reconsideration filed on June 7, 1982, by the American Telephone and Telegraph Company, on behalf of itself and the associated Bell System Operating Companies (AT&T). AT&T seeks reconsideration of the Commission's decision

in *Amendment of Part 31*, 89 FCC 2d 1094 (1982) (hereinafter cited as *Preemption Order*), in which the Commission determined that Sections 220(a) and 220(b) of the Communications Act of 1934, as amended, 47 U.S.C. 220(a) and 220(b), did not preempt state commissions from applying different accounting and depreciation procedures for purposes of intrastate ratemaking proceedings.[1] The *Preemption Order* was a reconsideration of *Amendment of Part 31*, 85 FCC 2d 818 (1981) (hereinafter cited as *Expensing Order*).

2. The Commission also has before it a Petition for Declaratory Ruling filed on June 7, 1982, by General Telephone Company of Ohio (GTE of Ohio). This petition requests that the Commission preempt an order of the Public Utilities Commission of Ohio (Ohio) that denied GTE of Ohio the same depreciation rates for intrastate purposes as had been prescribed by this Commission. GTE of Ohio contends that Section 220(b) established the rate prescribed by the Commission as the only depreciation rate the company could utilize.

3. The Commission established a joint reply period for the two petitions, utilizing the pleading cycle for comments in response to the Petition for Reconsideration, and allowed parties to cross-reference their pleadings where appropriate. In addition to pleadings filed by the petitioners and the GTE parties, comments or reply comments were

[1] On June 8, 1982, GTE Service Corporation, on behalf of itself, United Telephone System, Inc., and Continental Telecom, Inc. (hereinafter referred to as GTE), filed a Petition for Clarification of the Commission's *Preemption Order*. This petition was dismissed as untimely. *Amendment of Part 31*, Mimeo No. 4766 (released June 24, 1982). However, the Commission stated that it would consider the substance of the petition in connection with AT&T's petition.

filed by the Arkansas Public Service Commission (Arkansas), Ohio, the People of the State of California and the Public Utilities Commission of the State of California (California), the Virginia State Corporation Commission (Virginia), the National Association of Regulatory Utility Commissioners (NARUC), the United States Independent Telephone Association (USITA), the Office of Consumers' Counsel, State of Ohio (Consumers' Counsel), the United Telephone System Inc. and the Idaho Public Utilities Commission (Idaho). A summary of the comments is contained in Appendix A. Below we consider the issues raised on reconsideration, after which we shall consider the question presented by GTE of Ohio's Petition for Declaratory Ruling.

I. Background

4. In *Docket No. 19129*, 64 FCC 2d 1, 54-56 (1977), we concluded that it would be desirable to have the causative rate payer bear the costs associated with station connections. We directed AT&T to file a plan for accomplishing this objective. Following AT&T's submission we initiated this proceeding, albeit with a somewhat different approach for modifying the accounting for station connections than proposed by AT&T.

5. After reviewing the comments, we concluded that the drop, block and protector portion of station connections should not be included in any accounting or regulatory revisions. We also concluded that our objective of placing the costs of station connections on the cost causative customer could not be achieved by means of an accounting change alone. This is so because costs associated with the provision of inside wiring must be apportioned between the federal and state jurisdictions as long

as inside wiring is provided as a tariffed service subject to dual jurisdiction. Complete unbundling could be achieved by requiring inside wiring to be provided on a detariffed basis, as was done with customer premises equipment. Accordingly, we initiated a further inquiry to explore the detariffing concept further, *Amendment of Part 31*, 86 FCC 2d 885 (1981).

6. Nevertheless, we concluded that changes in accounting and depreciation procedures that would begin expensing the inside wiring portion of the station connection account would be in the public interest, and would facilitate the deregulation of the provision of inside wiring if the Commission should later decide to take that approach. The principal changes required that future costs of installing inside wiring and similar costs be included as an expense in Account 605, Repair of Station Equipment. Such costs were previously capitalized in Account 232, Station Connections. The expensing of these costs would be phased in over a four year period unless a carrier obtained state commission approval to expense one hundred percent immediately. The *Expensing Order* also required that the present net investment in inside wiring and the investment capitalized during the phase-in period be amortized over a ten year period. These expensing and amortization rules replaced the depreciation procedures that had previously applied to the inside wiring portion of the station connection account.

7. On reconsideration, we concluded that the *Expensing Order* was not intended to preempt state commissions from utilizing other depreciation or accounting procedures for intrastate ratemaking proceedings, unless such preemption occurs as a matter of law. Our discussion was based in part on an assumption that most or all of the state

commissions would follow our lead. We also indicated that Section 220 does not preclude state commissions from departing from accounting and depreciation rules prescribed by this Commission for purposes of regulating intrastate communications services. In reaching this conclusion, we reviewed Section 20(5), the Interstate Commerce Act predecessor of the accounting and depreciation provisions contained in Section 220. We concluded that nothing in the history of Section 20(5) provided any indication of whether that provision had been intended to preempt state commissions from prescribing divergent depreciation rates when the Interstate Commerce Commission (ICC) had prescribed a rate. We stated:

> [i]nasmuch as Section 20 had never been construed to restrict state commissions from requiring carriers to keep additional records for purposes of intrastate ratemaking and court decisions in analagous contexts did not adopt an expansive interpretation of that provision, the reenactment of that language should not be interpreted to restrict state commissions from keeping such additional records in the absence of clear evidence that the 1934 Congress intended to produce that result.

Preemption Order, supra at 1102.

8. We also reviewed the legislative history of the Communications Act and concluded that Congress had been uncertain of the preemptive effect of reenacting the Interstate Commerce Act language and that it apparently did not want to resolve the question at that time. We concluded that Congress had been attempting to obtain as much uniformity as possible without coercing any state commission to use ratemaking methods which it might find

unacceptable. We found that we had proceeded in a manner consistent with this purpose for nearly four decades, noting that we had recognized divergent practices by state commissions from time-to-time. The language of Section 2(b)(1) was found to support the interpretation that state commissions are not precluded from applying different accounting and depreciation procedures from this Commission. The *Preemption Order* concluded by finding that nothing in the Act precluded us from preempting state commission actions that might interfere with or tend to frustrate policies or rules we have adopted to carry out statutory objectives with respect to interstate or foreign communications, but we also found that federal regulation would not be frustrated if carriers maintain additional records for intrastate ratemaking purposes.

II. Discussion

9. The question presented in the reconsideration petition is a clearly delineated controversy over whether Section 220(b) preempts state depreciation prescriptions that are inconsistent with the rates prescribed for classes of property by this Commission, or, whether Section 2(b)(1) or Section 221(b) reserve to the states the right to prescribe their own depreciation rates for intrastate regulatory purposes. Alternatively, it is argued that the Commission should preempt inconsistent state depreciation rates pursuant to its authority to preempt state actions which would frustrate or interfere with the accomplishment of federal objectives. *See North Carolina Utilities Commission v. FCC*, 537 F.2d 787 (4th Cir. 1976), *cert. denied*, 429 U.S. 1027 (1976) (hereinafter cited as *NCUC I*). The *Preemption Order* was the first time the Commission had squarely addressed the preemptive effect of a prescribed depreciation rate, despite having prescribed rates for more than thirty

years. No federal court has addressed the question of the preemptive effect of a Commission prescribed depreciation rate.[2]

10. It is argued that the Commission erred in the earlier decision by concentrating on Sections 220(a) and 220(g) rather than properly analyzing Section 220(b), the provision dealing directly with depreciation. A careful review of AT&T's and GTE's pleadings and a thorough reevaluation of the entire question of the Commission's depreciation jurisdiction leads to the conclusion that the evaluation in the *Preemption Order* did not sufficiently consider the effect of Section 220(b). Accordingly, we shall undertake to evaluate anew the scope of the Commission's jurisdiction under Section 220(b).

11. Before turning to the analysis of the statutory provisions, it is necessary to understand the relationship between capitalizing and expensing a transaction or economic event. When an event is capitalized, its cost is recorded on the company's books to be recovered over some future period through depreciation charges to operating expense. Depreciation as used here is an accounting convention for allocatively spreading the original cost, less net salvage, over the useful life of a capital asset. Thus, for there to be depreciation there must be costs that are to be recovered over more than one accounting period. However, when the decision to expense is made, all costs are to be recovered at one time. Thus, the decision to

[2] The United States Supreme Court has held that state commissions may prescribe depreciation rates where the empowered federal commission has not prescribed rates. *Northwestern Bell Telephone Co. v. Nebraska State Railway Comm.*, 297 U.S. 471 (1936). The Court specifically reserved judgment on the effect of prescribed rates by the federal commission.

expense is a determination that there is no category of asset for which depreciation expense will be allowed. It is therefore clear that the decision to commence expensing the inside wiring portion of station connections involves questions of depreciation policy.

12. The law is clear that federal regulation should not be presumed to preempt state regulations without clear evidence of either congressional design to preempt the field or that state regulatory activities would obstruct the accomplishment and execution of the full purposes and objectives of Congress. *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 141 (1963), *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). Our review reveals that both criteria are satisfied in this case. In reaching this conclusion we analyzed the language of Section 220, the legislative history, relevant court cases, and our regulatory objectives.

A. *Statutory Language*

13. The Commission's express jurisdiction with respect to depreciation is set forth in Section 220(b). That section provides:

> The Commission shall, as soon as practicable, prescribe for such carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. Such carriers, shall not, after the Commission has prescribed the classes of property for which depreciation charges may be

> included, charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or, after the Commission has prescribed percentages of depreciation, charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses.

14. The plain language of the statute is express and unequivocal. Section 220(b) says the Commission "shall" make depreciation prescriptions, and that carriers "shall not" charge depreciation different than that prescribed by the Commission. That this preempts inconsistent state action is further indicated in Section 220(h) which gives the Commission discretion to "except" carriers from the requirements of Section 220 "where such carriers are subject to state commission regulation."

15. The requirement of Section 220(i) that states be given an opportunity to comment before the Commission prescribes "any requirements as to accounts, records and memoranda" is consistent with an interpretation that states are preeempted when the Commission has acted in the depreciation area. By providing that states be given notice, Congress ensure that state needs for accounts, records and memoranda brought to the Commission's attention would be considered. Such a procedure assures that the states' needs and legitimate interests are met.

16. In setting the duties of the Commission and the prohibitions on the carriers subject to the Act, Congress

spoke of depreciation in general terms without any attempt to make distinctions between either "intrastate" or "interstate" property. This is significant because when Congress wanted to make such distinctions in the Act it did so. See, *e.g.*, 47 U.S.C. 221(c) and (d), and 410(c). The fact that Congress did not make such a distinction here indicates that it intended no distinction.

17. Taken as a whole, the language of Section 220 appears clearly to preempt the states in connection with depreciation expense determinations and the related accounting. The language strongly implies that the states may not depart from depreciation rules prescribed by the FCC unless the Commission in its discretion allows them to do so. Otherwise, the federal statute would govern state depreciation practies in form only, allowing the states to treat substantive depreciation matters as they might choose. While that might be a plausible construction of Section 220, after full analysis we do not believe that Congress intended such a feeble gesture. There would be little purpose to require the carriers to keep all their books pursuant to an FCC prescription, and then allow the states to require the carriers to follow inconsistent depreciation practices. Instead, the language of the section and the comprehensive treatment given to this matter by the Congress demonstrate that more was intended. Accordingly, we find that the statutory language indicates that FCC depreciation prescriptions are to be followed in both the federal and state jurisdictions unless the FCC provides otherwise. As demonstrated below, this construction is also consistent with the legislative history.

B. *Legislative History*

18. In the *Preemption Order* we found that the

legislative history of Section 220 was inconclusive and at most indicated that Congress was "not sure" about the preemptive effect of the new legislation. 89 FCC 2d at 1106. However, the reconsideration petition and comments supporting it show that Congress believed that the language ultimately adopted would preempt the states from prescribing depreciation rates for subject carriers when the Commission had prescribed rates.

19. In our *Preemption Order*, we observed that Section 220 of the Communications Act had been adopted from Section 20 of the Interstate Commerce Act, and our review of the few ICC cases touching upon preemption did not reveal the ICC to have possessed the kind of broad preemptive power now urged by GTE and AT&T. However, after reviewing the pre-1934 cases again, we find that, while not dispositive, they lean more toward GTE and AT&T's views than against them.

20. The closest the ICC came to delineating its position on this matter came in *Depreciation Charges of Telephone Companies*, 118 I.C.C. 295, 332 (1926), where it said:

> It seems to be well established that where a local telephone company undertakes to originate or deliver toll messages, and most of them do so undertake, practically all of its property is open for use in interstate commerce and at any time may be so used. Under such circumstances, no doubt would seem to exist as to the power of Congress to regulate the accounting practices of such companies with respect to their property, including the accounting for depreciation.

In the *Preemption Order* we focused on the fact that the

ICC had not actually prescribed depreciation rates and thus there was uncertainty regarding the ICC's actual authority. However, after reviewing that case again we find that the better and more sensible interpretation is that if the ICC had prescribed depreciation rates, the state commissions would have been precluded from prescribing rates that diverged from those it prescribed. We cited *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133, 159 (1930), in the *Preemption Order* as supporting our conclusion that the ICC decision did not preempt the states. In that decision the Supreme Court held that absent ICC action prescribing depreciation rates, Section 20(5) did not preclude states from prescribing depreciation rates. Since the ICC proceeding did not actually prescribe depreciation rates, but only began a proceeding looking toward the ultimate prescription of depreciation rates, there were no depreciation rates prescribed that could have preempted state-prescribed depreciation rates. Thus *Smith* only stands for the proposition that until the ICC actually prescribed rates, there was no basis for preempting the states. It did not reach the question of whether Section 20(5) would preempt the states if the ICC prescribed depreciation rates.[3]

21. At the hearings pertaining to the Communications Act the then chairman of the ICC indicated his belief that the ICC depreciation rulings would govern both federal and state depreciation practices:

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[3] Similarly, *Interstate Commerce Commission v. Goodrich Transportation Co.*, 224 U.S. 194 (1912) and *Kansas City Southern Ry. Co. v. I.R.S.*, 52 F.2d 372 (8th Cir. 1931) do not appear to have any pertinance to the issue at hand. As noted in 89 FCC 2d at 1099, *Goodrich* did not raise any question with respect to the effect of ICC accounting rules upon activities not subject to ICC rate regulation. The *Kansas* holding simply reconciles two federal statutes, the Internal Revenue Code and the Interstate Commerce Act. It did not purport to establish new law on state preemption.

> Paragraph (j)...should be most carefully considered. It unquestionably directly conflicts with, and destroys the uniformity of systems of accounts and depreciation accounting required by the preceding provisions of the section. That is not true under the present law.[4]

22. Other witnesses who appeared at the hearing repeated the same view. See statements of Mrs. Gifford,[5] Mr. Benton,[6] and Dr. Irvin Stewart.[7]

23. The *Preemption Order* relied heavily on the "silence contained in the Congressional Reports," 89 FCC 2d 1105, in concluding that the legislative history did not support a finding that Section 220 was intended to preempt state commissions from prescribing their own depreciation rates for intrastate purposes. However, a reexamination of the legislative history in light of the comments on reconsideration indicates that the committee reports accompanying the bills did contain language indicating that the committees believed that the predecessor provision had preempted the states. The House Report, in discussing the Section 220(j) provision (which was not adopted) that would have reserved jurisdiction over depreciation rates to the states for purposes of intrastate ratemaking, stated that the provision was "responsive to the requests of the

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[4] Ltr. of F. McManamy, Hearings on S. 2910, p. 208.

[5] Hearings on H.R. 8301, pp. 191-192 (See 89 FCC 2d at 1105, fn.17). The *Preemption Order* had indicated that Mr. Gifford's preemption views were tentative. However, careful review of that testimony reveals that Mr. Gifford's uncertainty may have concerned the date Section 20(5) was enacted, not preemption.

[6] Hearings on S. 2910, 73rd Cong., 2d Sess., p. 181 (1943).

[7] Hearings on H.R. 8301, 73rd Cong., 2d Sess., p. 17 (1934).

State commissions that the present law be *changed so as to permit* those bodies to exercise, for State purposes, certain jurisdiction over...depreciation accounting."[8]

24. In remarks on the House floor, Representative Rayburn, Chairman, House Committee on Interstate and Foreign Commerce explained Section 220 of the proposed bill as follows:

> [p]aragraphs (a) to (g), relating to accounts records, memoranda, and depreciation, is based upon sections 20(5) to (8) of the Interstate Commerce Act with *changes necessary to permit State commissions to prescribe* the systems of accounts for the intrastate operation of carriers. Paragraphs (h) to (j) are new...*paragraph (j) removes any limitation upon the power of a State commission to prescribe, for the purposes of the exercise of its jurisdiction, rates of depreciation.* The last three paragraphs named were placed in the bill at the request of the State commissions which feel that their task of regulating intrastate communications will be greatly facilitated by the adoption of these paragraphs.[9]

25. The Senate version of Subsection (j) took a totally

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[8] H.R. Rep. No. 1850, 73rd Cong., 2d Sess. 7 (1934) (emphasis added). The section (j) proposed by the House would have provided: "Nothing in this section shall (1) limit the power of a State commission to prescribe for the purposes of the exercise of its jurisdiction with respect to any carrier the percentage rate of depreciation to be charged to any class of property of such carrier, or the composite depreciation rate, for the purpose of determining charges, accounts, records, or practices; (2) relieve any carrier from keeping any accounts, records, or memoranda which may be required to be kept by any State commission in pursuance of authority granted under State Law." H.R. 8301, 73 Cong., 2d Sess. Section 220(i) (February 27, 1934).

[9] 78 Cong. Rec. 10314 (1934) (emphasis added).

different approach than the House version. It called "for investigation and report to Congres instead of immediately turning over these matters to the State." S. Rep. No. 781, 73rd Cong., 2d Sess. 5 (1934).[10] The version of Section 220(j) finally enacted was the result of agreement in the conference committee. The conferees agreed to adopt the House provisions as to Sections 220(h) and (i), but decided against the House Section 220(j) proposal to remove any limitation upon the power of states to prescribe rates of depreciation. Instead, Section 220(j) was modified along the lines of the Senate proposal to require the Commission to "investigate and report to Congress as to the need for legislation to define or further harmonize the powers of the Commission and of State commissions with respect to other matters to which this section relates." Conf. Comm. Rep. No. 1918, 73rd Cong., 2d Sess. 17 (1934). The obvious inference to be drawn is that the conferees were not prepared at that time to allow the states to prescribe depreciation rates different than those established at the federal level, but that matter might be considered later if the report required by Section 220(j) indicated it to be appropriate.

26. The hearing testimony and Committee reports therefore indicate that the language being recodified from Section 20(5) of the Interstate Commerce Act preempted

[10] The Senate version of Section 220(j) provided: "The Commission shall investigate and report to the Congress whether in its opinion legislation is desirable (1) authorizing the Commission to except the carriers of any particular class or classes in any State from any of the requirements under this section in cases where such carriers are subject to State commission regulation with respect to matters to which this section relates; and (2) permitting the State commissions, in pursuance of authority granted under State Law, to prescribe their own percentage rates of depreciation or systems of accounts records, or memoranda to be kept by carriers." S. 3285, 73rd Cong., 2d Sess. Section 220(j) (March 28, 1934).

the state commissions' jurisdiction over depreciation. The rules of statutory construction provide that where Congress enacts a provision from an existing statute, it intends that the construction applicable to the existing provision apply as well to the new provision.[11] The legislative history thus supports the actual language of Section 220(b) and indicates that Congress intended to preempt state commission jurisdiction over depreciation rates for subject carriers when it recodified the language from the Interstate Commerce Act. Accordingly, we conclude that the analysis of the legislative history contained in the comments of AT&T and GTE accurately represents the intent of Congress and that the more persuasive reading of the legislative history supports the construction that Section 220(b) preempts inconsistent state action where the Commission has prescribed depreciation rates for a carrier.

C. *Administrative and Court Decisions*

27. The *Preemption Order* cited *Accounting Rules for Telephone Companies*, 203 ICC 13 (1934), as evidence that the FCC could not preempt state depreciation practices. There the ICC recognized that states might have additional accounting needs and indicated that it had permitted state-prescribed sub-accounts within the federally-required books of account. However, the adoption of a blanket subdivision rule does not lead to the conclusion that federally adopted accounting and depreciation rules are not preemptive. Rather, it reflects an awareness that state commissions may have special data requirements to properly

[11] Courts have given weight to interpretations of the Interstate Commerce Act in interpreting the Communications Act. See, *e.g.*, *American Telephone and Telegraph Company v. FCC*, 487 F.2d 865 (2d Cir. 1973).

administer their regulatory policies which may require additional detail beyond that prescribed by the federal agency. A subdivision rule, however, does not permit what is accounted for as an expense to be capitalized in the guise of subdividing an expense account. While we may allow subdivisions of accounts, we will not allow inconsistent accounting or depreciation methods unless such practices are otherwise consistent with the public interest. Any other policy would obliterate the prescriptive effect of our adoption of a uniform system of accounts.

28. In fact we have approved variations from the prescribed uniform system of accounts. For example, our rules give carriers blanket authority to subdivide certain prescribed accounts "provided such subdivisions do not impair the integrity of the accounts prescribed." 47 C.F.R. 31.01-2(d)(1). C.F. 31.01-2(f), authorizing carriers to subdivide accounts "in the manner ordered by any state commission having jurisdiction...." We also have approved state commission rate making treatment of plant under construction different from that adopted by us. See 89 FCC 2d at 1107.

29. There may well have been some instances of inconsistent state treatment of depreciation in the past. However, we do not seek controversy unless it is necessary to protect vital federal interests. Either such instances did not come to our attention or they may not have appeared threatening to federal interests.[12] In the past the communications marketplace was typified by monopoly conditions

[12] *Pacific Telephone and Telegraph Company v. California*, 401 P. 2d 353 (1965), was cited in the *Preemption Order* to support nonpreemption. However, the California Supreme Court did not analyze Section 220(b) or its legislative history and its determination is therefore unpersuasive.

and life and salvage factors underlying the state rates were generally very similar, if not identical, to those used by the Commission. In that environment it was not essential that the Commission assert all the authority granted it. See *Computer and Communications Industry Association v. FCC*, No. 80-1471 (D.C. Cir. November 12, 1982). As discussed, *infra.*, in the more competitive conditions prevailing today, the utilization of proper methods and rates is more critical if the proper incentives are to be created to insure that the marketplace will function efficiently to bring the benefits of the competition to the ratepayers of this country. Therefore, where it is necessary to protect important federal policies against frustration by inconsistent state actions, we will exercise the full breadth of our depreciation powers. *See* para. 14 above.

30. Nor is there any merit to the argument that federal preemption of depreciation practices constitutes intrastate ratemaking which might run afoul of 47 U.S.C. 152(b). Section 220(b) only prohibits the states from setting depreciation rates for telephone property inconsistent from those prescribed by the FCC. It does not require that any particular tariff for intrastate service be accepted by the state commissions. The setting of depreciation rates and classes of depreciable property only resolves a single issue impacting the ratemaking process. It does not restrict the state commission's broad discretion in setting charges for individual services. In any event, Section 2(b) of the Act, 47 U.S.C. 152(b), has a well defined purpose which would not be implicated here: "to restrain the Commission from interfering with those essentially local incidents and practices of common carriage by wire that do not substantially encroach upon the administration and development of the interstate telephone network." *NCUC I, supra* at 794 n.6. Here the setting of depreciation rates is not an essentially

local incident or practice and it has substantial effects upon the administration and development of the interstate telephone network.[13]

D. *Preemption Under Federal Supremacy*

31. Even if one were to assume that Section 220(b) did not automatically preempt the states whenever this Commission has acted, federal preemption of inconsistent state depreciation would be justified in this case to avoid frustration of validly adopted federal policies. The Fourth Circuit has stated:

> We have no doubt that the provisions of section 2(b) deprive the Commission of regulatory power over local services, facilities and disputes that in their nature and effect are separable from and do not substantially affect the conduct or development of interstate communications. But beyond that, we are not persuaded that section 2(b) sanctions any state regulation, formally restrictive only of intrastate communication, that in effect encroaches substantially upon the Commission's authority under sections 201 through 205.

NCUC I, supra at 793. To the same effect, see *Computer and Communications Industry Association v. FCC, supra* at 35.

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[13] Nor is federal preemption of depreciation practices inconsistent with 47 U.S.C. 221(b). Section 221(b) was intended to reserve state jurisdiction over exchange rates where exchange boundaries extend over two states. That provision was not intended to create new reservations to the states beyond that contained in Section 2(b) and the narrow circumstance encompassed by interstate exchanges. See *Computer and Communications Industry Association v. FCC, supra,* and *North Carolina Utilities Commission v. FCC,* 552 F.2d 1036, 1046 (4th Cir.1976), *cert. denied,* 434 U.S. 874 (1977) (hereinafter cited as *NCUC II*).

32. The D.C. Circuit recently addressed the preemption question, observing:

> We fail to see any distinction in this case between preemption principles applicable to state ratemaking authority and those applicable to other state powers. The operative principle [is that]...preemption of state tariffs on CPE is justified because state tariffs would interfere with the consumer's right to purchase CPE separately from transmission service and would thus frustrate the validly adopted federal policy.

Id. at 38. The court went on to find that conflicting state regulation may be preempted even though there is some indirect effect on state ratemaking discretion, noting:

> the Act itself does not distinguish between authority over rates and authority over other aspects of communications. Sections 2(a) and (b) of the Act allocated federal and state authority with regard to both "charges [and]...facilities." Therefore, conflicting federal and state regulations regarding dual use CPE are no more acceptable under the Act when equipment rates are involved, as here, than when interconnection policies are involved, as in the *NCUC* cases.

Id. at 38-39.

33. The provision for adequate capital recovery is important to "make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, world-wide wire and radio communication service with adequate facilities at reasonable charges...." 47 U.S.C. 151. State depreciation rate prescriptions that do not adequately provide for capital recovery in the competitive environment,

which constitutes this Commission's policy in those markets found capable of supporting competition, would frustrate the accomplishment of that policy and are preemptable by this Commission.

34. Over the past decade the Commission has embarked in several areas of telecommunications to pursue a policy of encouraging competition wherever the market conditions will support such a policy and produce benefits to the public interest. In *MTS-WATS Market Structure Inquiry*, 81 FCC 2d 177 (1980), the Commission opened the domestic MTS-WATS market to competitive entry, reserving the question of entry to Alaska to a later phase since concluded with the adoption of a similar open entry policy, *MTS-WATS Market Structure Inquiry*, FCC 82-515 (released November 30, 1982). In *Computer Inquiry II*, 77 FCC 2d 384 (1980), *recon.*, 84 FCC 2d 50 (1980), *recon.*, 88 FCC 2d 512, *aff'd subnom., Computer and Communications Industry Association v. FCC, supra*, the Commission opened the areas of enhanced services and customer premises equipment to competitive provision. These are just two examples of the policies which the Commission has pursued. However, they do point up the fact that if this policy is to be successful, it will be necessary for the marketplace to operate efficiently. Such efficient operation requires proper price signals generating from supply and demand conditions.

35. Capital recovery is an important determinant of the price at which services can be offered and significantly affects the amount of facilities provided to supply the needs of the communications industry. In *Amendment to Part 31*, 83 FCC 2d 267 (1980), *recon.*, 87 FCC 2d 916 (1981), the Commission adopted remaining life and straight line equal life group depreciation methods that recover capital

on a basis that approximates straight line unit depreciation more closely than did the previously used methods. More timely capital recovery was anticipated to result in faster technological innovation with its accompanying benefits of more efficient service provision and lower costs resulting from more productive use of facilities.

36. Capital recovery issues are important in the implementation of *Computer Inquiry II* due to the part depreciation plays in the determination of net book value and the resultant gain or loss that may occur on the transfer of assets to the new subsidiary. It will also be significant in any later transfer of assets from the provision of regulated service to unregulated service or vice-versa. Thus, appropriate capital recovery will ease the regulatory burdens associated with supervising the transition to the new structure.

37. Depreciation is a significant portion of the revenue requirement of the regulated telephone companies. As such, it plays an important role in determining the price at which they offer their services. If competition is to be viable, it is necessary for prices to reflect depreciation expenses that are realistic for a competitive market. Absent such depreciation levels, improper signals will be given to the market. Since most plant is used interchangeably to provide interstate and intrastate communications service, supply and demand is determined by the combination of inputs from service demand in both regulatory jurisdictions. Approximately 75 percent of exchange plant is allocated to the intrastate jurisdiction. It is clear that unless telephone plant, including that portion subject to allocation to the intrastate jurisdiction, is depreciated at a reasonable rate, improperly time capital recovery will occur. Indeed, in a increasingly competitive environment, it is possible that

improper capital recovery could delay or prevent modernization which would add to the costs borne by ratepayers and could, ultimately, threaten carriers' ability to fully recover their invested capital. Moreover, the extent of state action attempting to prevent carriers from utilizing our depreciation prescriptions places substantial burdens on carriers and could well impair their ability to raise the investment capital they will need to fully compete in the continually evolving competitive telecommunications marketplace.[14] Such a result could undermine the achievement of the Commission's objective to develop policies that will engender a dynamic, efficient telecommunications marketplace with services being provided at reasonable prices.

38. NARUC contends that preemption with respect to station connections is unnecessary and will not produce competitive benefits because expensing is not the same as unbundling. While NARUC is correct in a strict sense, it avoids the critical issue, which is the proper timing of cost recovery. If the Commission preempts with respect to station connections and all states must expense these costs, current ratepayers will be paying these costs instead of future ratepayers as would be the case with capitalization. Thus, future prices will reflect the appropriate costs for providing those services. Moreover, if these costs are

[14] AT&T and GTE indicate several state commission have refused to follow, have indicated an intent not to follow, or are being urged not to follow Commission determinations with respect to the expensing of inside wiring and/or the adoption of straight-line equal life group or remaining life depreciation methods. A staff review of state action in conjunction with AT&T intrastate tariff proceedings reveals that all but two states have approved expensing of station connections, that 13 states have rejected and 12 have approved equal life group depreciation, and that 9 states have rejected and 22 have approved remaining life group depreciation. Prior to issuing our *Order* in this docket we did not expect that such significant variance would be required by states.

expensed and state commissions must allow rates to cover these costs, it is likely that the cost causative ratepayer will in many cases be charged for the costs being expensed in connection with the provision of inside wiring. Thus, the Commission's objective may be substantially achieved by preempting state commissions from departing from our expensing rules.

39. In 1971 Congress amended the Communications Act to change the procedures for allocating costs between federal and state jurisdictions by adding Section 410(c). The Commission was given the ultimate authority with respect to such allocations, further solidifying its superintendency over common carrier communications. See *NCUC I, supra* at 795. Section 410(c) procedures provide for uniformity in the separations process, thereby insuring that plant, expenses and revenues will be rationally accounted for in the dual jurisdictional environment. The utilization of one depreciation rate is the most effective method for insuring that this uniformity will be maintained and to insure that no jurisdiction bears a greater burden than another in the transition to a fully competitive marketplace. Several parties suggest that under or over recovery will result from one jurisdiction or another because of the shifting usage patterns for telephone plant over time and argue that if such a result were to occur, significant inequities would result to both ratepayers and carriers. A uniform depreciation rate for each class of property applicable to all property whether allocated to the federal or state jurisdiction clearly eliminates these potential problems.

40. For all of these reasons, it is apparent to us that a substantial impact on federal policies could result if state commissions were allowed to diverge from Commission

prescribed depreciation rates and practices. Accordingly, it is essential to preempt inconsistent state depreciation practices to avoid frustration of these vital national policies.

III. Declaratory Ruling Petition.

41. GTE of Ohio seeks to have the Commission preempt an order of the Ohio Public Utilities Commission that did not approve remaining life and equal life group rates for intrastate ratemaking purposes. As alleged by GTE of Ohio, the differential in rates amounts to seven million dollars per year. GTE of Ohio states that failure of this Commission to preempt the state will frustrate the achievement of federal policies adopted by this Commission. Its argument is similar to those cited in connection with the reconsideration petition.

42. Essentially the same arguments are made against the GTE of Ohio petition as were urged on reconsideration with regard to the substance of the issue. However, Ohio cites an Ohio statute that precludes the state commission from adopting remaining life depreciation for intrastate purposes.

43. One procedural argument is raised by Ohio with respect to the petition. It contends that the question presented is premature since the order is subject to further reconsideration before the Ohio Commission pursuant to a request filed by GTE of Ohio. We do not agree since the purpose of declaratory rulings is to give guidance to affected persons in areas where uncertainty or confusion exists. A case or controversy in the judicial sense is not required, *NCUC I, supra* at 790-1. In this case, it appears necessary to issue such a ruling to clarify for the state

commissions and the carriers the effect of our depreciation prescriptions. The fact that reconsideration proceedings are under way in Ohio does not mitigate against such a course in light of the divergencies from this Commission's depreciation methods and rates that are occurring to the detriment of federal policies. Thus, we find it imperative to declare today that inconsistent state prescribed depreciation rates are preempted by the Communications Act and are accordingly void. The existence of a state statute preventing a state commission from adopting a particular method does not affect this determination. When federal preemption is involved, there is no difference between a statute or a regulation of a state commission. Both must fall in the face of overriding federal concerns and policies.

IV. Conclusion

44. We have carefully reviewed the record upon reconsideration. The issues raised concerning the *Preemption Order* caused us to reevaluate the statutory language of Section 220(b), the legislative history of the provision, and the relevant judicial and administrative proceedings relating to the subject. Our considered judgment after this review is that the *Preemption Order* must be reconsidered. We find that the most logical and reasonable interpretation of Section 220(b) of the Act is that where the Commission prescribes depreciation rates for classes of property, state commissions are precluded from departing from those rates. Since the depreciation method utilized is a material part in determining the rate to be applied, state commissions are also precluded from departing from the depreciation methods prescribed by the Commission. Thus, the *Expensing Order* is binding upon state commissions and they must expense additions to inside wiring in accordance with the plan established therein. Moreover, they must follow

the amortization procedures adopted in that decision for the embedded inside wiring and any additions to the capitalized amount as a result of the phase-in of the expensing of inside wiring.

45. Even if Section 220(b) does not preempt state commissions, we would act under our authority to preempt state actions that interfere with the accomplishment of federal policies and objectives. *Computer and Communications Industry Associaton v. FCC, supra,* and *NCUC II.* We note that petitioner and the parties supporting the petition cite several states that have indicated they do not intend to follow the Commission's depreciation prescriptions or expensing of inside wiring, or have refused to follow either. In light of the concerns expressed about an efficiently functioning market, we must find that inconsistent depreciation rates prescribed by state commissions will interfere with the efficient operation of the communications marketplace and thereby frustrate the achievement of the Commission's policies. Accordingly, we find that this Commission's depreciation policies and rates, including the expensing of inside wiring, preempt inconsistent state depreciation policies and rates.

46. Accordingly, IT IS ORDERED, pursuant to Section 1, 4(i), and 220(b) of the Communications Act of 1934, as amended, 47 U.S.C. 151, 154(i), and 220(b), That the Petition for Reconsideration filed by the American Telephone and Telegraph Company IS GRANTED.

47. IT IS FURTHER ORDERED, That the Petition for Declaratory Ruling filed by General Telephone Company of Ohio IS GRANTED to the extent reflected herein.

48. IT IS FURTHER ORDERED, That the

Secretary shall cause this order to be published in the Federal Register.

49. IT IS FURTHER ORDERED, That the Secretary shall cause a copy of this order to be served on each state commission.

FEDERAL COMMUNICATIONS COMMISSION

William J. Tricarico *Secretary*

Appendix A. Summary of Comments

1. AT&T argues that the Commission on reconsideration should find that state commissions are precluded from departing from the depreciation methods and rates established by this Commission in order to allow the carriers to achieve timely capital recovery. It views the *Preemption Order* as a retreat from the Commission's competitive policies.

2. AT&T asserts that realistic depreciation rates are essential to attain accurate cost-based pricing decisions to prevent artificial barriers to competition, to foster technological innovation which will enhance network efficiency and the availability of competitive alternatives, to facilitate the timely implementation of the detariffing of customer premises equipment[1] and to insure the financial viability of the carriers. It contends that competitive conditions result in faster obsolescence and shorter asset lives, requiring that depreciation methods and rates be inseparable from ratemaking to insure capital recovery.

[1] It contends that different depreciation rates between jurisdictions will result in disagreements about net book value in deregulating CPE and that the application of the Separations Manual will create uncertainty as to which plant a particular book value relates.

3. AT&T proposes two legal theories for preempting state commission action. First, it asserts that the Commission may preempt under Sections 1 and 2 of the Act, citing *California v. FCC*, 567 F.2d 84, 86 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1010 (1978), *NCUC II*, *NCUC I*, and *NARUC v. FCC*, 533 F.2d 601 (D.C. Cir. 1976). It states that because of the central role depreciation, including the depreciation aspects of station connections, plays in the achievement of the Commission's policies, preemption is necessary to avoid interference with or frustration of these policies.

4. AT&T's second theory is that Section 220(b) preempts states on its face, asserting that in its earlier pleadings it did not rely on Section 220(g) as suggested by the Commission's decision. It argues that Section 220 gives the Commission discretion with respect to accounting rules, but does not give it such discretion with regard to depreciation prescriptions. AT&T states that the Commission's rule allowing carriers to subdivide an account to comply with a state commission order does not mean that a state can require capitalization when this Commission requires expensing. Finally, it submits that the Commission misread the legislative history of the Communications Act by failing to consider statements in the committee reports and remarks of members at committee hearings that indicate Congress believed the Interstate Commerce Act provisions from which Section 220(b) was taken did in fact preempt the states. See also *Depreciation Charges of Telephone Companies*, 118 I.C.C. 295 (1926).

5. GTE asserts that the Commission's policies in the areas of competition and faster capital recovery will be frustrated if the state commissions are allowed to depart from the depreciation rates and methods prescribed by the

Commission. It contends that Section 220(b) preempts the states and distinguishes Section 220(a) as being discretionary on the Commission and argues that the Commission focused only on the provisions of Section 220(a) in its earlier decision. It submits that there is no doubt that a state can require a carrier to keep additional records and memoranda. However, GTE argues that the Commission's decision is overly broad. It is clear, GTE contends, that the Commission can preempt inconsistent state action when it conflicts with national telecommunications policies, and it should do so in this case. GTE also argues that the legislative history and the rules of statutory construction indicate that Congress intended to preempt the states in the area of depreciation, submitting that property cannot be successfully depreciated at two different rates prescribed by different regulatory bodies because under or over recovery from one or the other jurisdiction will occur from the use of shifting usage factors.

6. The oppositions generally argue that the states have the jurisdiction to determine the extent to which intrastate rates reflect depreciation and expensing adjustments promulgated by the Commission. Sections 2(b) and 221(b) are cited as reserving jurisdiction over local and intrastate telephone rates to the states as intended by Congress when it distinguished between "interstate" and "intrastate" in Sections 1 and 2. Ohio argues that the preemption argument was rejected in the only case of which it is aware, *Pacific Telephone and Telegraph Company v. California*, 401 P. 2d 353 (1965).

7. Ohio asserts that the courts have distinguished between ratemaking and interconnection policies, *NCUC II* and *NCUC I*, and submits that it is the ratemaking jurisdiction reserved to the states that is in question in this

proceeding. To permit the Commission to prescribe depreciation rates applicable to all property whether used for interstate or intrastate services would, in Ohio's view, be equivalent to giving the FCC a hand in setting state rates.

8. Ohio is concerned that under some methods, such as remaining life, costs will not be charged to consumers who receive the benefits of the property being depreciated. Finally, it contends that Sections 220(i) and (j) are consistent with concurrent jurisdiction.

9. Ohio argues that GTE is attempting to have the Commission read Section 2(b) out of the Act, and asserts that it is inappropriate to ignore language in a statute, to extend a statute beyond its clear import, or to embrace subjects not specifically enumerated. Section 2(b)(1) is stated by Ohio to have been intended to reverse the Supreme Court decision in *Houston East and West Texas Ry. v. U.S.*, 234 U.S. 342 (1914), wherein the ICC was given the power to suspend intrastate rates enabling carriers to raise intrastate rates to federal levels for similar distances. NARUC and Ohio argue that section 2(b) was intended to ensure that state jurisdiction was not limited by the 1934 legislation.

10. Several parties assert that there is considerable Commission precedent recognizing the states' independent ratemaking authority, including departures from Commission prescribed accounting, for intrastate rates. They note that the Commission has encouraged state commissions to devote more resources to depreciation matters. *Amendment of Part 31*, 83 FCC 2d 267 (1980) *recon.*, 87 FCC 2d 916 (1981), has recognized in this proceeding the state jurisdiction over expensing of station connections for state

ratemaking purposes, has recognized divergent treatment of interest during construction and has not contested California's use of remaining life for approximately thirty years. Ohio argues that there is nothing to suggest that there needs to be national uniformity in depreciation procedures and that local diversity is desirable, noting that even a GTE of Ohio witness in an Ohio rate case has indicated that local diversity in setting depreciation rates is preferable.

11. Ohio contends that *McDonnell Douglas Corp. v. General Telephone Company of California*, 594 F.2d 720 (9th Cir. 1979), recognized the validity of intrastate regulatory jurisdiction under the Act by finding that Congress in enacting Section 2(b) had intended to give states considerable power with respect to wire communications that are wholly intrastate in nature.

12. California argues that the Commission's refusal to preempt state power to prescribe depreciation rates for intrastate ratemaking purposes will not undermine the Commission's procompetitive policies or signal a retreat since many states have adopted policies that foster competition. AT&T's assertion that preemption must be exercised to promote procompetitive policies is rejected by NARUC as unsupported. It states that expensing of station connection costs can have no competitive effect because expensing is not the same as unbundling. Moreover, it contends that the Commission did not adopt remaining life and equal life group depreciation procedures to promote competition but, rather, to more properly time capital recovery and insure that any deficiency in past depreciation was adjusted. Finally, NARUC states that the speculative statements about the numbers of states that are not following the Commission's policies are

inadequate to justify preempting state commission jurisdiction on the theory that federal policies are being frustrated.

13. NARUC argues that the attempted distinction of Section 220(a) from Section 220(b) on the basis that Section 220(b) is mandatory while Section 220(a) is discretionary does not address the question of the preemptive effect of either section. It contends that neither reason nor case law provides support for asserting that preemption of state regulation of intrastate communications is automatic with respect to subject areas which the FCC must regulate on the interstate level. It further notes that the language of Section 220(g) with respect to the effect of prescribed depreciation rates, accounts or records other than as prescribed by the Commission. NARUC states that the relationship between accounting and ratemaking is self evident and argues that state control over intrastate rates would have little vitality if state commissions were deprived of the power to disallow expenses and depreciation claimed by carriers. NARUC asserts that the fact that a proposed Section 220(j) that would have expressly reserved depreciation prescription powers to the states was not adopted does not mean that states must be bound by Commission depreciation prescriptions, stating that the final provision adopted was a compromise.

14. Consumers' Counsel supports the Commission's *Preemption Order* and generally cites from that *Order* in support of its position. Idaho also agrees with the conclusion of the Order and states that it believes that administrative costs of separate record keeping to meet state requirements will be small. Arkansas filed to indicate that its opinions had not rejected the new depreciation methods outright but had left the decision to individual cases for resolution.

15. AT&T's reply submits that the setting of

depreciation rates does not constitute the exercise of jurisdiction with respect to charges for intrastate services. It argues that Section 2)b) does not deprive this Commission of jurisdiction over jointly used property where its regulation affects the conduct or development of interstate communications. AT&T states that if a state utilized the depreciation rate prescribed by the Commission, it may make adjustments to the test period data to reflect concepts of used and useful property or other pro forma adjustment to reflect conditions during the period during which the tariff will be in effect.

16. AT&T distinguishes *Houston East and West Texas Ry. Co. v. U.S., supra*, by asserting that that case involved actual preemption of service rates. It notes that while Congress may have sought to reverse that decision in the communications field, the issue here is only the jurisdiction to prescribe depreciation rates. Thus, it contends that the case actually suggests that Section 2(b) should be narrowly interpreted. Moreover, while use of federally prescribed depreciation rates may significantly affect intrastate rates, the states remain free to price individual service rates. See *e.g., NCUC I.*

17. USITA submits that federal preemption of jurisdiction over depreciation rate prescriptions for carriers for which the Commission has prescribed depreciation rates would not interfere with state commission ability to set intrastate service rates in accordance with any ratemaking method desired. It contends that the setting of depreciation rates is not a ratemaking function pursuant to Sections 201-205, but is the exercise of a specific power granted to the Commission by Congress. USITA argues that divergent depreciation rates create confusion and raise problems of capital recovery.

18. GTE contends that state action whether in the nature of ratemaking or otherwise which "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" will be preempted. *Fidelity Federal Savings and Loan Association v. de la Cuesta*, 50 LW 4916, 4919 (1982). GTE concludes that the states do not have the power through the guise of ratemaking to negate FCC action designed to give effect to federal statutory objectives. GTE does not challenge state rights pursuant to state statutes to regulate rates for intrastate services. It asserts that no preclusion of state ratemaking jurisdiction would result from FCC preemption under Section 220(b), although failure to preempt will endanger important national policies.

19. GTE submits that Section 220(b) charges the Commission with the responsibility of prescribing depreciation rates for carriers subject to the Act and recognizes only two exceptions. First, the Commission should act as soon as possible. Second, Section 220(h) recognizes that certain classes of carriers may be exempted. The Commission, according to GTE, has not exercised its authority pursuant to this provision in this proceeding. Finally, GTE argues that reliance on *NCUC I* and *NCUC II* as supporting a finding that the Commission cannot preempt state commission depreciation prescriptions for carriers subject to the Act is inconsistent with the holdings and analysis of those cases. AT&T and GTE submit that Section 221(b) is inapplicable because that provision was intended only to give states the jurisdiction to regulate local exchange service extending over a state boundary.

SEPARATE STATEMENT OF COMMISSIONER JOSEPH R. FOGARTY

IN RE: RECONSIDERATION OF DOCKET NO. CC 79-105.

Having dissented from the Commission's original decision declining to preempt State accounting and depreciation rules inconsistent with those prescribed by the FCC,[1] I am pleased that the Commission has reconsidered this issue and acted to preempt such inconsistent State regulation.

As this *Order* establishes in detail, a true reading of the statutory language and legislative history of Section 220(b) of the Communications Act clearly demonstrates that Congress intended FCC depreciation rules and policies to control the field.

Even if preemption were not explicity mandated by Section 220(b), the effective implementation of our procompetitive federal telecommunications policies dictates that inconsistent State depreciation regulation be preempted by this Commission. We cannot "defer to the States" on capital recovery issues. Telephone companies must be able to recover their cost of capital in a timely and effective manner if they are to price their services efficiently and to improve and expand their facilities to meet the challenges of competition and technologic innovation.

This preemption imperative is not merely theoretical. Too many States (e.g., Alabama, Louisiana, Nebraska, Ohio, New Jersey, Michigan, Arkansas) have already refused to

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[1] Amendment of Part 31, Joint Dissenting Statement of Commissioners Joseph R. Fogarty and Anne P. Jones, 89 FCC 2d 1109-1111 (1981).

recognize the critical necessity of the FCC's cost recovery principles. The resulting depreciation rate differentials are alarming: GTE of Ohio has indicated that it will be denied $7 million in capital recovery this year if the State of Ohio's disparate depreciation treatment is allowed to prevail.

The FCC cannot ignore the detrimental impacts of inconsistent State treatment of depreciation if our pro-competitive policies are to have any integrity and viability. This Commission now recognizes that preemption is both mandated as a matter of law and essential as a matter of policy, and our action today has my full endorsement and support.

APPENDIX "B"
JUDGMENT

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF LOUISIANA

CIVIL ACTION
NO. 83-557-A

SOUTH CENTRAL BELL TELEPHONE COMPANY

VERSUS

LOUISIANA PUBLIC SERVICE COMMISSION,
ET AL

ORDER FOR PRELIMINARY INJUNCTION

This cause came on for hearing of Plaintiff's Motion for Preliminary Injunction. The Court having considered the evidence herein, heard the oral arguments of counsel and reviewed the briefs filed, finds and orders as follows:

1) The Court has jurisdiction to issue the injunction sought under 47 U.S.C. §401(b).

2) The Johnson Act, 28 U.S.C. §1342, is not a bar to this action.

3) The Plaintiff is entitled to a preliminary injunction and a preliminary injunction should issue.

4) Unless an injunction is issued, the Plaintiff will suffer irreparable harm inasmuch as neither Defendants nor this Court can authorize Plaintiff to recover retroactively any revenues lost during the pendency of the underlying cause of action on the merits.

5) No harm will accrue to the other parties to this proceeding or to the Plaintiff's ratepayers inasmuch as neither Defendants nor this Court can authorize Plaintiff to recover retroactively any revenues lost during the pendency of the underlying cause of action on the merits.

5) No harm will accrue to the other parties to this proceeding or to the Plaintiff's ratepayers inasmuch as Plaintiff will place the rates at issue in effect subject to refund with interest and will refund any amounts so collected should the January 6, 1983, FCC Order in Docket 79-105 not be upheld on appeal. Collection of rates subject to refund with interest is adequate security under FRCP Rule 65(c).

6) The Court finds that it is in the public interest of insuring compliance with the Congressional mandate of developing nationwide uniformity in telecommunications policy to enforce a binding FCC order regarding depreciation rates and methodologies while it is in effect.

7) Plaintiff has demonstrated a likelihood of prevailing on the merits of this case.

8) WHEREFORE, for the reasons stated, it is hereby ordered:

That a preliminary injunction issue against Defendants requiring them to abide by the FCC's January 6, 1983, Order regarding depreciation rates and methodologies until this action is finally resolved and, within ten (10) days of the date of this order, issue an order which provides for the collection of rates by Plaintiff sufficient to recover the intrastate revenue requirement resulting from the FCC-prescribed depreciation rates and methodologies.

These rates will be subject to reasonable refund provisions as the Defendant may authorize should Plaintiff not prevail on the merits of this case and which will include provisions to make refunds to those customers who terminate service of the Plaintiff during the effective dates of the injunction.

Baton Rouge, Louisiana, June 27, 1983.

/s/ JOHN V. PARKER

JOHN V. PARKER, CHIEF JUDGE
MIDDLE DISTRICT OF LOUISIANA

APPENDIX "C"
NOTICE OF APPEAL

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 83-3494

SOUTH CENTRAL BELL TELEPHONE COMPANY,

Plaintiff-Appellee,

versus

LOUISIANA PUBLIC SERVICE COMMISSION, THOMAS E. POWELL, GEORGE J. ACKEL, ED KENNON, LOUIS LAMBERT and JOHN G. SCHWEGMANN, JR.,

Defendants-Appellants.

On Appeal from the United States District Court
for the Middle District of Louisiana

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that the Louisiana Public Service Commission, appellee, appeals to the Supreme Court of the United States from the decision of the United States Court of Appeals for the Fifth Circuit dated October 11, 1984, affirming the decisions of the United States District Court for the Middle District of Louisiana dated June 27, 1983 and August 1, 1983.

This appeal is taken pursuant to 28 U.S.C. §1254(2).

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APPENDIX "D"
STATE RATEMAKING ORDERS

LOUISIANA PUBLIC SERVICE COMMISSION

ORDER NO. U-15445

DOCKET NO. U-15445

SOUTH CENTRAL BELL TELEPHONE COMPANY
(NEW ORLEANS, LOUISIANA).

ex parte

In re: Proposed revision of its intrastate rates and charges for telephone service within the State of Louisiana.

This case involves the application of South Central Bell Telephone Company ("South Central Bell" or "the Company") requesting an increase in its intrastate rates and charges for the service it renders in the amount of $238,600,000.00. The Company also requested an increase in certain of its tariffs applicable to the provision of private line services. Interventions were filed by Common Cause of Louisiana, the Louisiana Telephone Answering Service Committee, the Louisiana Alarm Association, the Division of Administration of the State of Louisiana and the United States Department of Defense. The Company, intervenors and the Commission pre-filed testimony and exchanged data requests and responses. Hearings were conducted on December 13, 14, and 15, 1982, and January 17, 18, and 19, 1983.

South Central Bell is a Delaware corporation doing business as a public utility in the State of Louisiana. The last rate increase received by the Company in Louisiana was on January 21, 1981 when an increase in intrastate rates of $51,408,000.00 was approved by this Commission. *Ex Parte South Central Bell Telephone Co.*, Order No. U-14673 (La. Pub. Serv. Comm. 1981).

During the period since the last rate case when rates were adjusted to produce an additional $51,408,000.00 annually for this Bell operating company, the state of the economy has resulted in unprecedented unemployment exceeding 12% in this State alone and many industrial corporations and businesses have experienced and are experiencing operating losses in the millions of dollars. While at the same time, the rate of inflation has substantially abated and interest rates have declined appreciably.

In the light of the foregoing especially since the Company has earned a rate of return comparable to that found to be reasonable by the Commission in the last rate proceeding, we find no justification for an increase in rates at this time.

Accordingly,

IT IS HEREBY ORDERED that South Central Bell's request for an increase in its intrastate rates in the amount of $238,600,000.00 is denied.

BY ORDER OF THE COMMISSION:
BATON ROUGE, LOUISIANA
MAY 19, 1983

/S/ THOMAS E. POWELL
CHAIRMAN

/S/ ED KENNON
COMMISSIONER

/S/ LOUIS J. LAMBERT, JR.
COMMISSIONER

*Commissioner John Schwegmann concurs in part and dissents in part.

/S/ JOHN F. SCHWEGMANN
COMMISSIONER

/S/ GEORGE J. ACKEL
VICE CHAIRMAN

/S/ LOUIS S. QUINN
SECRETARY

* (Separate Opinion Attached)
[Opinion of Commissioner Schwegmann omitted]

LOUISIANA PUBLIC SERVICE COMMISSION

ORDER NO. U-15445-A

DOCKET NO. U-15445

SOUTH CENTRAL BELL TELEPHONE COMPANY
(NEW ORLEANS, LOUISIANA),

ex parte

In re: Proposed revision of its intrastate rates and charges for telephone service within the State of Louisiana.

This case is before the Commission pursuant to an order of the United States District Court for the Middle District of Louisiana, Honorable John V. Parker, which was issued on June 27, 1983.

In May, 1982, South Central Bell Telephone Company ("South Central Bell" or "the Company") requested an increase in its intrastate rates and charges in the amount of $238.6 million. Included within that rate request was a request for more than $40 million in revenues that the Company alleged it would need if the Commission adopted certain methodologies for computing the expenses of the Company prescribed by the Federal Communications Commission ("FCC").

Specifically, South Central Bell asked the Commission to employ, for the purpose of intrastate ratemaking, Equal Life Groups and Remaining Life depreciation

methods rather than the Straight Line Vintage Life Group method which had previously been employed by the Commission and consistently approved by the courts of this State. In addition, South Central Bell sought to have the Commission "expense" 75 per cent of the costs associated with station connections, rather than capitalizing these costs as the Commission had done in the past. At the hearings of the rate case, South Central Bell alleged that the FCC had *mandated* the use of the new methods in an Order issued January 6, 1983 Memorandum Opinion and Order, CC Docket No. 79-105 (FCC, Jan. 6, 1983). The net effect of the adoption of these proposals would have been to increase the Company's intrastate expense level by $40,506,000.

After extensive hearings on the rate request, this Commission issued Order No. U-15445 (Commissioner Schwegmann concurring in part and dissenting in part). In light of unprecedented unemployment levels, the state of the economy, the fact that inflation has substantially abated, the decline in interest rates and the fact that the Company had earned a rate of return comparable to that found reasonable in the last rate proceeding, among other factors, this Commission denied the Company's rate request. However, the Commission did not make a finding at that time of the fair rate of return on equity for South Central Bell, since no increase in revenues was required.

On May 19, 1983, South Central Bell filed suit in the Federal court seeking the issuance of a preliminary injunction ordering the Commission to recognize the FCC-mandated depreciation rates. On June 27, 1983, the Honorable John V. Parker ordered that within 10 days the Louisiana Public Service Commission "issue an order which provides for the collection of rates by (South Central

Bell) sufficient to recover the intrastate revenue requirement resulting from the FCC-prescribed depreciation rates and methodologies". It is this ruling by a federal judge ordering the Louisiana Commission to increase *intrastate* rates which forces the Commission to issue this Order.

This Commission is the body constitutionally vested with the duty and authority to regulate all common carriers and public utilities providing intrastate service in Louisiana. We believe that this most recent attempt by the FCC to preempt this State's authority to regulate intrastate rates and services is inconsistent with the Communications Act and may run afoul of the limitations contained in the United States Constitution protecting state sovereignty. However, we are faced with an order of a federal judge which has not yet been overturned. Although we believe that the order is invalid, we are compelled to obey it at this time. For that reason we will reconsider the case in light of the increased expense level of $40,506,000 resulting from the FCC Order. (Although the Company asked the federal court to increase revenues in the amount of $41,463,000, that request was based on 1983 data, none which was ever presented to the Commission. The appropriate figure based on test year data reviewed by the Commission is $40,506,000).

As noted, the Commission denied the rate request of South Central Bell in May, but did not make a determination of the fair rate of return on equity. The currently authorized overall rate of return of South Central Bell was set in 1981, when market interest rates were significantly higher than they are today. The prime rate has remained at about 10½ per cent for some time. In addition, the rate of return earned by the Company includes a return on unamortized investment tax credits, which constitute

approximately 7.5 per cent of South Central bell's total capital. In fact, however, these tax credits are cost-free investment of the Company, so in reality the rate of return on its investor-supplied equity is higher than that authorized for regulatory purposes. When these factors are viewed in light of the continued low level of inflation, and continued high unemployment, we find that a rate of return on equity of 12 per cent is sufficient to assure confidence in the Company's financial soundness, will be adequate to maintain and support its credit and will permit it to raise the capital necessary to perform its public functions. The gross revenue increase necessary to produce a rate of return on equity of 12 per cent after taking account of the ratemaking adjustments proposed by a consultant of the Commission, Bruce M. Louiselle, and recognizing the full amount of the FCC-mandated accounting changes as quantified by South Central Bell, is $12,700,000.

The increase in rates approved in this Order shall be distributed as follows:

ITEM	AMOUNT
Basic Local Flat Rate Exchange and Related Services; Including Residence and Business basic local service, Centrex Access Measured PBX, etc.	$ 1,000,000
Service Charges	1,000,000
Miscellaneous Services: 2,000,000 Including Toll Terminals, Grouping Service, Zone Charges, etc.	
Network Services	2,000,000
Customer Premises Products	6,000,000
Unrecovered Telephone Equipment Charge	700,000

Total Billing Charge	$12,700,000
Less Independent Company Settlements	(257,000)
	$12,443,000

Accordingly,

IT IS HEREBY ORDERED THAT:

(1) South Central Bell Telephone Company be permitted to increase its tariffs in the amounts directed by the Commission sufficient to increase its gross annual revenues by $12,700,000;

(2) This increase shall be implemented subject to refund with interest at 12 per cent per annum and the Commission reserves the right to require further security from the Company;

(3) No increases shall become effective until such time as the Company files and the Commission accepts tariffs drawn in accordance with this order and which provide for a refund plan which includes provisions for refunds to ratepayers who discontinue or change service during the time that these increased rates are in effect.

BY ORDER OF THE COMMISSION:
BATON ROUGE, LOUISIANA
JULY 7, 1983

/s/ THOMAS E. POWELL
CHAIRMAN

COMMISSIONER

/s/ LOUIS J. LAMBERT, JR.
COMMISSIONER

*Commissioner John Schwegmann concurs in part and dissents in part.

COMMISSIONER

/s/ GEORGE J. ACKEL
VICE CHAIRMAN

/s/ LOUIS S. QUINN
SECRETARY

* (Separate Opinion Attached)

Commissioner Schwegmann, concurring in part and dissenting in part,

At the time of the decision of the South Central Bell rate case, I stated the position that a maximum rate increase of $21,989,000 should be granted the Company in view of the burdensome effect of any increase on consumers. This increase would have produced a 14 per cent rate of return on equity.

I agree that the federal court order should be complied with in full, recognizing that full $40.5 million in accounting changes sought by the Company. After giving effect to this increase in expenses, I would still raise the revenues of the Company by the gross amount (after independent company settlements) of $21,989,000. This increase would produce a rate of return on equity of 12.6 per cent. I recognize that this rate of return is below the amount I deemed reasonable in May, but I believe we still must balance the investor interests against the interests of consumers, and in light of all relevant factors, this rate of return is still reasonable.

/s/ JOHN F. SCHWEGMANN
JOHN F. SCHWEGMANN, Commissioner

LOUISIANA PUBLIC SERVICE COMMISSION

GENERAL ORDER

In re: Reaffirmation of the applicability of state regulatory principles to telephone terminal equipment and telephone accounting practices.

This General Order is issued to set forth the scope of regulatory authority over telephone tariffs that is exercised, and will continue to be exercised absent a contrary and authoritative judicial order, by the Louisiana Public Service Commission. In the view of the Commission, this statement of regulatory policy is necessary because of orders issued by the Federal Communications Commission ("FCC") which attempt to preempt the authority of this Commission and other state regulatory agencies to regulate certain intrastate activities of communications common carriers.

In a proceeding generally known as the "Second Computer Inquiry," the FCC last year stated its intention to preempt the authority of state regulatory agencies to establish tariffs for the marketing of "terminal equipment" by communications common carriers. "Final Decision," In the Matter of Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry) (hereinafter referred to as "Second Computer Inquiry"), Docket No. 20828, 77 F.C.C. 2d 384 (Released May 2, 1980); "Memorandum Opinion and Order" in Second Computer Inquiry, 84 F.C.C. 2d 50 (Released Dec. 30, 1980). "Terminal equipment" is that equipment located on

a customer's premises which the customer uses to transmit and recieve communications through the telecommunications network. Thus, it includes equipment ranging from the ordinary telephone to the sophisticated equipment used on the premises of businesses. The action of the FCC is designed to further an asserted federal policy of "deregulation" and would permit the Bell System, along with other common carriers, to set the prices for terminal equipment free of rate regulation by any state regulatory agency or the FCC. In the words of the FCC, the Second Computer decision has the effect of "eviscerating state jurisdiction to establish charges for this terminal equipment in a manner that conflicts with federal interests...." Memorandum Opinion and Order in Second Computer Inquiry, 84 F.C.C. 2d 50, 103 (Released Dec. 30, 1980).

The Louisiana Commission did not learn of the scope and potential impact of the decision in the Second Computer Inquiry until recently. Although the ruling attempts a vast reordering of federal and state regulatory prerogatives, no public notice issued by the FCC prior to its Final Decision even mentioned the possibility that any preemption of state authority might be attempted. The Second Computer Inquiry was orignially undertaken to redefine the distinctions between communications and data processing services previously adopted by the FCC. Notice of Inquiry and Proposed Rulemaking in Second Computer Inquiry, 61 F.C.C. 2d 103 (Released Aug. 9, 1976); Supplemental Notice of Inquiry and Enlargement of Proposed Rulemaking in Second Computer Inquiry, 64 F.C.C. 2d 771 (Released March 8, 1977); Tentative Decision and Further Notice of Inquiry and Rulemaking, 72 F.C.C. 2d 358, 440-43 (Released July 2, 1979).

The potential consequences of the regulatory policies

of the FCC began to become apparent, however, when South Central Bell Telephone Co. requested drastic increases in intrastate rates to satisfy prospective changes in depreciation rates and other accounting practices prescribed by the FCC. See *Ex parte South Central Bell Telephone Co.*, Order No. U-14673 (La. Pub. Serv. Comm'n., Jan. 21, 1981) at 30 *et seq.* These accounting changes are associated with the process of deregulation and are designed in part to allow the telephone company an accelerated return of capital to permit the transfer of assets to an unregulated Bell System subsidiary at low prices. Final Decision in Second Computer Inquiry, 77 F.C.C. 2d 384, 449 (Released May 2, 1980). Faced with the claim for substantial intrastate rate increases to promote federal objectives, this Commission initiated an inquiry into the scope and impact of the Second Computer decision and related actions of the FCC. *Ex parte South Central Bell Telephone Co.*, Order No. U-14673 (La. Pub. Serv. Comm'n., Jan. 21, 1981) at 30 *et seq.*

The Second Computer decision, if it is implemented, will have a number of consequences for state regulatory agencies and intrastate ratepayers. First, the state agencies will be precluded from regulating the Bell System and other common carriers in the marketing of terminal equipment. Consumers will be forced to pay whatever prices can be exacted by these carriers in light of local market conditions. Second, state regulatory agencies will be unable to foster the goal of universal service by permitting the rates for terminal equipment, which ordinarily reflect at least the full intrastate and interstate cost of this equipment, to defray part of the expenses associated with basic service. Thus, intrastate rates will increase. Third, the other actions of the FCC taken to implement the deregulation decision, such as the prescription of accelerated depreciation rates, will cause intrastate rates to increase even further.

The attempted preemption of state ratemaking authority by the FCC is ironic because the FCC has never established the tariffs for most enhanced services, nor do federal tariffs exist for most of the terminal equipment provided to consumers by common carriers. The establishment of these rates has historically been the prerogative of state regulatory agencies.

Much of the plant devoted to communications service in this country is devoted to both intrastate and interstate use. Thus, a piece of terminal equipment may be used primarily for intrastate calls in the local exchange and intrastate toll calls, but it may also be used for interstate toll calls. A similar joint use is made of the inside wiring on the customer's premise, the wiring that connects customers to switching facilities, some of the central office equipment, and other plant. Under the decision of the United States Supreme Court in *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133, 51 S.Ct. 65 (1930), a fair apportionment is required of the costs attributable to each jurisdiction in order to fairly account for these costs. Over time, a separations process has developed to accomplish this objective. Of the joint costs, which are apportioned in part according to the use of the facilities, the majority are assigned to the intrastate jurisdictions.

While the costs associated with terminal equipment are divided between the state and federal jurisdictions, the responsibility for tariffing jointly used terminal equipment has always rested with the state regulatory agencies. Thus, the FCC recognized that the only federal tariffs for terminal equipment involve equipment used exclusively in "interstate or foreign communications" and that all terminal equipment subject to the separations process is "tariffed at the state level." Memorandum Opinion and

Order in Second Computer Inquiry, 84 F.C.C. 2d 50, 67, 66 (Released Dec. 30, 1981).

The objectives of regulation on the intrastate level vary from state to state. However, one general objective of utility regulation is to ensure that an entity enjoying "natural monopoly" status does not charge excessive prices to consumers. A second objective is to ensure the ready availability to the general public of common carrier services: the concept of universality of service. Regulatory agencies may act to ensure that communications service is provided to all who request it at reasonable prices. These regulatory policies have long been accepted in Louisiana.

The method by which regulatory agencies protect the consumer, while ensuring the financial health of the utility, is through the ratemaking process. As Professor Priest indicates in his treatise, "(e)very state has...established a regulatory agency" and "the early predicates for regulation were developed under the guidance of state tribunals." A.J.G. Priest, Principles of Public Utility Regulation (Michie Co., 1969) at 26. The ratemaking process is designed to set utility prices at a level that will allow only a fair rate of return to the utility. *Id.* at 191 *et seq.* The overriding principle is the "protection of the public interest." *Id.* at 193.

Generally, only communications common carriers have been regulated in the marketing of terminal equipment. The prices charged by independent suppliers of terminal equipment, that do not engage in common carrier actaivities, have not been regulated. The only companies "deregulated" by the FCC are the Bell System and other common carriers. The Bell System, however, enjoys enormous economic power in the United States. South Central

Bell Telephone Co. has natural monopoly status in this state. In only a few areas of the state do market conditions reflect any significant "competition" in the marketing of terminal equipment. In most areas, an unregulated telephone company would be free to charge excessive prices.

A full implementation of the deregulation decision of the FCC, including the changes in accounting practices proposed to further the goal of deregulation, could cause increases in Louisiana intrastate rates of more than $100 million annually. The economic power of the Bell System would be enhanced. Consumers would be unprotected in obtaining terminal equipment from a natural monopoly. The policy of universal service would be retarded.

The Louisiana Constitution and other laws of this State vest this Commission with regulatory authority over the telephone company. This law provides the Commission with broad authority over regulated utilities. Concomitantly, the Commission has a duty to exercise its authority in reasonable fashion to protect consumers while ensuring fairness to utilities. The law of the State and our longstanding regulatory policies do not permit the Commission to meekly accede to an ill advised policy of regulatory abdication advocated by a federal agency.

In the view of this Commission, the Communications Act of 1934 specifically reserves to the states the authority to prescribe rates for equipment used primarily for intrastate communications. 47 U.S.C. §§152(b), 221(b). Even if it did not, the attempt of a federal agency to displace our authority to protect Louisiana citizens, while providing no assurance that federal regulations will protect them, runs afoul of constitutional limitations protecting state sovereignty. National League of Cities v. Usery, 426 U.S. 833, 96 S.Ct. 2465 (1976).

In order to place the FCC and South Central Bell Telephone Co. on notice of the regulatory policy of this State as it relates to the policies announced by the FCC, this Commission hereby orders:

(1) The marketing of terminal equipment by communications common carriers will continue to be the subject of rate regulation by this Commission, even after March 1, 1982. This order will apply to any attempt of the Bell System to market this equipment through a separate subsidiary.

(2) Depreciation rates for imbedded terminal equipment, and all other equipment historically regulated in the intrastate jurisdiction, will be set according to policies approved in this State. They will not be established to further a policy of "deregulation" of the FCC.

(3) Changes in accounting procedures proposed by common carriers will be examined for their consistency with the approved regulatory practice of this State and will be approved or disapproved on this basis, and thi- basis only.

The staff, special counsel and consultants of the Commission are instructed to take the necessary actions to ensure the implementation of this Order. The Order does not reflect any change in the regulatory policy of this Commission. However, it is necessary in light of the policies announced by the FCC.

BY ORDER OF THE COMMISSION
BATON ROUGE, LOUISIANA
JUNE 30, 1981

/s/ ED KENNON
CHAIRMAN

/s/ THOMAS E. POWELL
VICE CHAIRMAN

/s/ LOUIS J. LAMBERT, JR.
COMMISSIONER

/s/ GEORGE J. ACKEL
COMMISSIONER

/s/ JOHN F. SCHWEGMANN
COMMISSIONER

/s/ LOUIS S. QUINN
SECRETARY

BEFORE THE
LOUISIANA PUBLIC SERVICE COMMISSION

DOCKET NO. U-15955

EX PARTE APPLICATION OF
SOUTH CENTRAL BELL TELEPHONE COMPANY
FOR A REVISION OF ITS INTRASTATE
RATES AND CHARGES

ORDER NO. U-15955-A

I. INTRODUCTION

This case involves the application of South Central Bell Telephone Company ("South Central Bell") for an increase of its intrastate rates and charges of $407,337,000. The case involves unprecendented issues in telecommunications because it requires the Commission to set rates for the period following the divestiture of South Central Bell and other Bell operating companies by the American Telephone and Telegraph Co. ("AT&T") pursuant to the settlement of the antitrust suit brought against AT&T by the Justice Department. The settlement was modified and approved by a United States District Court in *United States v. American Telephone & Telegraph Co.*, 552 F.Supp. 131 (D.D.C. 1982), *aff'd sub. nom., Maryland v. United States*, __ U.S. __ (1983). In addition, this case follows the decision of the Federal Communications Commission preempting state jurisdiction over certain services and offerings of telecommunications commcn carriers and deregulating these areas. *Computer & Communications Industry Ass'n v. Federal Communications Commission*, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied sub. nom. Louisiana*

Public Service Commission v. Federal Communications Commission, __ U.S. __ (1983).

The company filed its rate application November 4, 1983. It requested general rate relief, but also asked for an interim, emergency rate order to make up revenues assertedly to be lost January 1, 1984 as the result of divestiture and deregulation. On December 30, 1983, the Commission issued Order No. U-15955, granting the company authority to file access tariffs sufficient to produce annual revenues of $141.5 million, with the charges to be assessed entirely to interexchange carriers. This amount was later reduced to about $138 million by agreement of South Central Bell and the principal interexchange carrier, AT&T Communications of the South Central States, Inc. ("ATTCOSCSI"), a subsidiary of AT&T.

South Central Bell formerly was a wholly owned subsidiary of AT&T. It now is a wholly owned subsidiary of Bell South Corporation ("BellSouth"), a corporation that was "spun off" by AT&T at the time of divestiture. Southern Bell Telephone & Telegraph Company is also a wholly owned subsidiary of BellSouth. To accomplish the divestiture, South Central Bell transferred most of its customer premises equipment ("CPE") to a subsidiary of AT&T and transferred other equipment, assets and personnel to other entities.

Interventions were filed in this proceeding by a number of parties, including ATTCOSCSI, the Alarm Association of Louisiana, Southern Pacific Communications, Southern Message Service, Inc., Radiofone, Inc., the American Petroleum Institute's Central Committee on Telecommunications, Louisiana Telephone Association, Lafourche Telephone Company, and the Regulatory Law

Office, U.S. Army Legal Services Agency. A hearing was conducted on the interim application December 8, 1983, and hearings for the cross-examination of witnesses presented by South Central Bell, the Commission Staff, and intervenors were held April 10, 11 and 12, and May 15, 16 and 31, 1984.

II. THE RATE APPLICATION

In a normal rate case, determining the revenue requirements of the utility requires five steps: 1) choosing the test period for the measurement of the earnings of the company; 2) calculating the rate base in the test period; 3) finding the adjusted operating income for the period; 4) determining the fair rate of return; and 5) adjusting rates to allow the utility the opportunity to earn this rate of return. Traditionally, the Commission has used a past test period and adjusted the data for known changes to occur when rates are in effect and, if necessary, for attrition.

In this case, the traditional rate-making mechanism is complicated enormously by divestiture and deregulation. Because of these events, historic data is not necessarily indicative of future conditions. The splitting of the assets, personnel, offerings and services of the company do not necessarily have a proportionate impact on expenses and revenues, so it is impossible to predict the rate levels for the divested company that are necessary to produce the fair rate of return. Moreover, because of divestiture and deregulation, the rate filing is based to an unprecedented degree on assumptions and estimates, many of which were made by employees of AT&T or employees of South Central Bell who are now employed by AT&T. The presumptive validity attaching to the books and records of a utility in a normal case, when this material is kept in accordance

with standard and accepted accounting practices, does not apply to the unique decisions made in connection with the reorganization of the industry, especially since an entity that is now a potential competitor of South Central Bell controlled many divestiture decisions.

In addition, because divestiture was a mammoth task, involving decisions by hundreds of employees of AT&T and South Central Bell, it is impossible to test these decisions for their prudence and regulatory propriety. This Commission simply does not have resources to match those devoted by the telephone company to this effort. Thus, regulatory scrutiny in the normal sense is not possible.

These observations do not mean that rates should not be established for the post-divestiture period, but that any prognostication of the impact of these events is unreliable and the capacity of the Commission to protect the interests of ratepayers is reduced. The rate setting process requires an unusual dose of judgment. The handicaps under which the Commission must set rates mandate caution in analyzing the company's forecast of a need for additional revenue.

A. The Test Year.

South Central Bell proposed the use of a fully forecasted 1984 test year. The Commission traditionally has relied on actual data for a recent past test year, but recognizes that divestiture and deregulation make past data unreliable for predicting the future. Nevertheless, the use of actual data, adjusted to the extent possible, for divestiture, is likely to be more representative, and permit better regulatory scrutiny, than data based entirely on estimates. Therefore, the Commission adopts the test year

1983. South Central Bell was given the opportunity to suggest all necessary adjustments to this data.

B. The Rate Base.

The Commission adopts the rate base proposed by its regulatory consultant, Mr. Kenneth Gallagher. The adjustments proposed by Mr. Gallagher are consistent with the traditional practices of the Commission and reflect reasonable adjustments to the estimates proposed by the telephone company. The Commission notes that the estimates of 1984 separations factors made by South Central Bell increase the rate base by $125 million as compared to the 1983 factors. These estimates were not supported in any detail by the company and could not be checked by the Commission's consultants.

In addition, it should be noted that given the impact of divestiture, it is no longer necessary to separate customer deposits into intrastate/interstate components. The amount to be properly deducted from the intrastate rate base is the entire unseparated amount.

South Central Bell recently spun off its directory assistance operation to a subsidiary of BellSouth. The consultants of the Commission indicated that even though South Central Bell will receive a percentage of directory assistance revenues, these revenues will decrease. Pursuant to their recommendation, South Central Bell is directed to maintain its records in a manner that will permit the Commission to determine in the future the revenues lost because of the spin off. For the test year, only an adjustment to working capital is required to achieve the proper ratemaking treatment of the directory assistance matter.

The adjusted rate base is set forth below:

RATE BASE FOR TEST YEAR 1983

($1,000)

Telephone Plant in Service		2,347,680
Depreciation Reserve		(315,530)
Net Telephone Plant		2,032,150
Long-Term Telephone Plant Under Construction		22,971
Short-Term Telephone Plant Under Construction		24,545
Property Held for Future Use		335
Working Capital		(15,372)
Less: Non-Investor Supplied Capital		
Customer Deposits Including Interest	(13,064)	
Accumulated Deferred Income Taxes	(249,249)	
Pre-1971 Investment Tax Credits	(1,293)	
Reserve for Uncollectibles	(1,355)	
Total Non-Investor Supplied Capital		(264,961)
CPE Phase-Out		(18,457)
Capitalized CPE Transfer		290
Rate Base		1,781,501

C. Adjusted Operating Income.

The net operating income for 1983 was adjusted for divestiture. Mr. Gallagher recommended that a number of further adjustments proposed by South Central Bell be

accepted and that others be rejected. In addition, he proposed several adjustments to this data. The recommendations of Mr. Gallagher all appear reasonable and are adopted by the Commission. Only the following adjustments require discussion.

1. Changed divestiture ratios.

Mr. Gallagher recommended that the ratios for the computation of certain payroll adjustments be changed from those proposed by the company. South Central Bell developed the ratios using a post-divestiture forecast of the number of employees in 1984 and a pre-divestiture forecast for 1984, though the 1983 number of employees was used to price out the adjustments. With respect to the test year labor costs, Mr. Gallagher's adjustment to reflect the effect of the actual number of employees retained upon divestiture is accepted. The revised proforma wage adjustments proposed by Mr. Gallagher are also accepted. Mr. Gallagher's method of comparing the post-divestiture actual number of employees to the 1983 figures used to develop the pre-divestiture adjustment is the correct procedure to develop the appropriate ratios.

2. Reimbursements.

The company received reimbursements from AT&T for expenses previously financed by ratepayers. These funds should be amortized back to ratepayers over a reasonable period, as recommended by Mr. Gallagher.

3. General Services and Licenses—
Central Service Organization.

Mr. Gallagher estimated the amount of General

Services and Licenses expense and the Central Service Organization expense by starting with and adjusting the 1983 License Contract expense. The Commission approves this method, which is a reasonable method of projecting this expense. The Commission adopts Mr. Gallagher's recommendations concerning the divestiture ratios to be applied to various expense categories and the removal of certain categories for ratemaking purposes.

4. Adjustment to Previously Deferred Research Costs.

South Central Bell retained 100 per cent of previously deferred research costs rather than transferring some of these costs, along with assets, to AT&T. Mr. Gallagher recommended that only a percentage of these costs be recognized for ratemaking treatment, since research improved all of the company's technology, including that transferred to AT&T. A portion of the research costs will be amortized to ratepayers as recommended by Mr. Gallagher.

5. Depreciation and Expensing of Station Connections.

In 1983, the Commission rejected the implementation of certain accounting changes approved by the Federal Communication Commission and assertedly made mandatory for state regulatory agencies in a Preemption Order issued by the FCC. South Central Bell obtained a preliminary injunction from a federal court requiring that the additional book expenses be recognized and that a rate increase be granted, subject to refund, to permit the collection of these expenses. The increase was approximately $41 million. The decision is now on appeal to the United States Court of Appeals for the Fifth Circuit.

The expense in the test year for these items for the post-divestiture South Central Bell causes the need for additional revenues of approximately $41 million. The 1984 represcriptions recently approved by the FCC require additional revenues of $21.72 million. In sum, then, the total revenue effect of the mandated changes in depreciation methods and rates is approximately $62.7 million.

Except for the federal court order, the Commission would not approve the new depreciation methods or the expensing of station connections. However, because of the preliminary injunction, the additional expenses will be recognized for ratemaking purposes, pending the decision of the courts on the appeal of the preliminary injunction.

The rates attributable to these expenses will be imposed subject to refund. South Central Bell is directed to keep records sufficient to make the necessary refunds.

6. Amortization of Excess Deferred Income Taxes.

Due to the change in the federal income tax rate, the Company has accumulated "excess" deferred taxes. The deferred taxes were accumulated at a 48 per cent rate, but the tax liability now only reflects a rate of 46 per cent, meaning that funds have been accumulated for which there is no tax liability. The company proposes to return this excess to its ratepayers over the life of the plant which gave rise to the deductions. It asserts that this treatment is in accord with generally accepted accounting principles and also that if the company returned these deferred taxes more rapidly to ratepayers it would jeopardize its ability to defer federal income taxes pursuant to the Internal Revenue Code.

Mr. Gallagher recommended that these excess deferred taxes be amortized to ratepayers over a two year period. These excess deferred taxes have arisen as a result of accounting convention and do not in fact constitute a potential liability of the Company. The money was advanced by ratepayers. The Company has offered no reason to support its retention of these funds for any longer than two years.

Finally, there is no indication that South Central Bell runs a significant risk of losing its ability to defer federal income taxes if these excess deferred taxes are amortized over a two year period. The Commission will still permit the normalization of the tax effects of accelerated depreciation. In addition, various other state regulatory commissions have required that such excess reserves be amortized over a shorter period of time than the life of the associated plant and there have been no adverse effects on the ability of the regulated companies to defer federal taxes.

7. Interest during construction.

Interest during construction should be reflected at the overall cost of capital approved by the Commission, both for long-term and short-term plant under construction. The appropriate adjustment at the rate of return of 11.82% is $651,000.

8. Tax effect of proforma interest.

Mr. Gallagher indicated that the test year tax expense be adjusted to reflect the proforma amount and cost rate of debt adopted for ratemaking purposes. This recommendation is consistent with the standard practice of the Commission and is adopted.

The adjustments to operating income are set forth below:

ADJUSTED OPERATING INCOME

($1,000)

Test Year Net Operating Income		90,717
ADJUSTMENTS		
Annualize 4/83 Management Salary Increase	(400)	
ES, CPE, FSS Reimbursements	1,401	
AMPS Reimbursement	760	
8/83 Tariff Increase	8,205	
Annualize 8/83 Non-Mgmt. Salary Increase	(2,924)	
Annualize 10/83 Management Salary Increase	(1,564)	
Annualize 1983 Pensions Accrual Increase	(396)	
Annualize Independent Company Settlements	238	
Remove Divestiture "Get Ready" Costs	227	
Annualize RL/ELG—1983	(4,460)	
Remove ASD Formation Costs	316	
Remove Regional Service Company Costs	2,659	
Proforma Non-Management Savings Plan	(76)	
Proforma 1984 FICA	(386)	
Proforma 4/84 Management Salary Increase	(529)	
Proforma 8/84 Non.-Mgmt. Salary Increase	(4,172)	
Proforma 10/84 Management Salary Increase	(683)	

Proforma 1984 Property Tax Increase	(1,693)	
Proforma 1984 Revenue—ATTIX/ EBO	376	
Proforma 4/85 Management Salary Increase	(989)	
ESC—100%	(9,676)	
Adjust Test Year Payroll for Divestiture Ratio	8,910	
Amortization of Reimbursements	178	
CPE Phase-Out	3,463	
CPE Transfer to Employees	234	
Official Toll	(2,284)	
Contract Charging	(4,016)	
Adjust IDC to 11.82	651	
Interest on Customer Deposits	(648)	
Amortization of Excess DFIT	1,536	
Proforma Interest	9,772	
12/83 Tariff Change	(1,084)	
RL & ELG—1984	(10,877)	
Total Adjustments		(7,931)
Adjusted Net Operating Income		82,786

D. Fair Rate of Return

The determination of the fair rate of return is also influenced by divestiture and deregulation. In the past, the Commission has regulated South Central Bell on the basis of a reasonable capital structure for the Bell System. The company has now been divested and is wholly owned by BellSouth. In addition, the Commission now must determine a reasonable return on equity for the divested company rather than for a company that is part of the Bell System.

Dr. Richard L. Lurito, a consultant of the Commission, testified that a reasonable capital structure for BellSouth would include 45 per cent long term debt, 6 per cent short term debt and 49 per cent common equity. In the 1980 South Central Bell case, Docket No. U-14673, this Commission used a capital structure containing only 45 per cent equity for regulatory purposes; this capital structure was also used in the last case. Thus, the recommendation of Dr. Lurito would permit a significant increase in the equity ratio.

Under the divestiture order of the federal court, the divested Bell subsidiaries were required to have equity ratios of at least 55 per cent. However, the divestiture order does not purport to determine a reasonable capital structure of these subsidiaries for regulatory purposes. The 55 per cent requirement is partly a function of the historic refusal of the Bell System to move toward a reasonable capital structure and the court's desire to avoid exploitation of the subsidiaries by AT&T. It is not binding on this Commission.

Dr. Lurito performed studies to determine whether his recommended capital structure provides adequate safety to South Central Bell and found that it ensures more than a reasonable margin of safety. This finding is especially supportable because other utilities in this State with fewer assets and greater risk than South Central Bell are able to obtain reasonable financing with equity ratios below 40 per cent. The Commission is reluctant to approve any increase in the equity ratio, but will adopt the recommendation of Dr. Lurito for this case with the provision that to conform to the regulatory goal in this State, the utility plan its future financing to achieve the most economical capital structure and equity ratio.

Dr. Lurito also provided the proform cost of debt of South Central Bell and BellSouth and indicated that it may be preferable to use the cost rates of South Central Bell until experience shows the effect on the BellSouth cost rates of its creation of certain new subsidiaries. The Commission will accept this recommendation, at least for this case.

The following recommendations were submitted for the fair rate of return on equity:

Mr. J. D. Matheson, Jr., the witness of South Cental Bell	16-18%
Dr. Lurito	15%
Mr. Mark Langsum, the witness of the U.S. Army	13.5-14.5%

In evaluating these recommendations, the Commission is mindful of the following tenets. First, the company is entitled to earn a rate of return that is "commensurate with returns on investment in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain credit and to attract capital." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 288 (1944). This, however, is but the first part of the Commission's inquiry. The Commission is also bound to "provide appropriate protection to the relevant public interests, both existing and foreseeable." *In re Permian Basin Area Rate Cases,* 390 U.S. 747, 792, 88 S.Ct. 1344, 1373 (1968). Furthermore, the Commission is bound to assess these requirements of the broad public interest "at each step of its regulatory process." 390 U.S. at 791, 88 S.Ct. at 1372. A balance must thus be struck between investor and consumer interests.

Second, unamortized investment tax credits constitute approximately 8.1 per cent of South Central Bell's total investor-supplied capital. If such unamortized investment tax credits are not deducted from the Company's rate base, South Central Bell will in fact be permitted the opportunity to earn a higher rate on its *actual* equity investment. Although these unamortized investment tax credits are treated as if they were investor-supplied, they actually have zero cost to the Company. If the unamortized investment tax credits are deducted from rate base, there might be a disadvantageous tax consequence. However, the Commission is not precluded from considering this factor in determining the rate of return on equity that will ensure the financial integrity of the utility.

Third, inflation continues to be relatively low. Investors are receiving a higher *real* return on their investment than they have for some time. The use of historic studies concerning the investor's required rate of return may overstate the real return requirement.

Fourth, the preliminary injunction requires the Commission to permit faster capital cost recovery methods than historically have been allowed. The increase in cash flow of $62.7 million annually reduces the investment risk of South Central Bell and gives it a better "quality" of earnings.

In the final analysis, the fair rate of return on equity is a matter of regulatory judgment. This rate of return will be fixed at 14.75 per cent. The overall fair rate of return is 11.82 per cent.

E. Revenue Requirement.

To produce the fair rate of return, a rate increase of $126,393,000 is required after reflecting the fact that access rates charged to interexchange carriers will produce $128,790,000 of revenues, as discussed below. South Central Bell has assured the Commission that it will pursue a construction program costing $300 million or more in the next 12 months, allowing it to improve and upgrade the quality of service in this State. The Company will be required to perform this undertaking, especially in light of the rate relief provided in this order.

III. ADDITIONAL MATTERS.

The following additional matters must be dealt with in this Order.

First, divestiture and deregulation have created a new telephone company and shifted much of the burden of paying for telecommunications services among classes of customers. New issues in rate design are presented. The goal of universal service is threatened by the spectre of so-called "competition," which in the world of the telephone company mandates increases rather than decreases in price. A full analysis of these issues is necessary. Therefore, the Staff is directed to receive evidence and make recommendations concerning these matters. However, the Commission hereby orders that the increase applied to residential exchange service not exceed $2.00 per month and the increase to business exchange service not exceed $4.00 per month, and authorizes the implementation of these two tariffs.

Second, pursuant to the recommendation of Bruce

M. Louiselle, a Commission consultant, and the current cost study showing the need for $128,790,000 in revenue resulting from the loss of the toll services of South Central Bell, the access charge assessed to interexchange carriers will be fixed at $128,790,000. The so-called threat of "bypass" has not been shown to be serious enough to justify reducing these tariffs any further.

Third, the Commission is concerned that accounting guidelines be developed to ensure that interexchange carriers bear the full cost of ensuring "equal access" pursuant to the divestiture order. In the continuing proceedings, the Staff is directed to analyze this issue and make recommendations.

Fourth, the Commission Staff is directed to conduct an examination of the contracts between AT&T and South Central Bell for the use of multifunction plant to determine their reasonableness and the extent to which the divestiture order affects the freedom of the Commission to adjust these expenses for regulatory purposes.

Fifth, South Central Bell will from time to time be required to construct projects to serve the needs of interexchange customers. Procedures must be developed to permit regulatory scrutiny of these projects and the compensation received from AT&T and other carriers. The staff should analyze these issues in the continuing proceeding.

IV. CONCLUSION

For the foregoing reasons,

IT IS ORDERED that South Central Bell Telephone Company will be permitted to raise its intrastate rates in

the gross amount of $126,393,000. After the implementation of the increase, $62.7 million of the revenues of South Central Bell will be subject to refund. In addition, these proceedings shall remain open to formulate recommendations regarding the other issues described in this Order. The Company is also ordered to expend at least $300 million on construction, to improve and upgrade service, in the 12 months beginning September 1, 1984.

BY ORDER OF THE COMMISSION:
BATON ROUGE, LOUISIANA
OCTOBER 1, 1984

/s/ GEORGE J. ACKEL
CHAIRMAN

/s/ JOHN F. SCHWEGMANN
John Schwegmann concurs in part and dissents in part.*
VICE CHAIRMAN

/s/ Ed Kennon dissents.
COMMISSIONER

/s/ THOMAS E. POWELL
COMMISSIONER

/s/ LOUIS J. LAMBERT
COMMISSIONER

/s/ LOUIS S. QUINN
SECRETARY

* Commissioner Schwegmann concurs in all parts of this Order except the decision to approve an additional $21.72 million in depreciation expense for 1984 represcriptions approved by the FCC. Commissioner Schwegmann would approve this additional expense only if it were mandated by the courts. Commissioner Schwegmann would approve a rate increase of $104,673,000.

* Commissioner Lambert concurs in all parts of this Order except the decision to approve an additional $21.72 million in depreciation expense for 1984 represcriptions mandated by the FCC. Commissioner Lambert would deny the depreciation expense. However, Commissioner Lambert agrees that a rate increase of $126,393,000 is necessary to ensure the financial viability of the telephone company and permit it to make necessary capital expenditures. Therefore, Commissioner Lambert joins Commissioners Ackel and Powell in approving a rate increase of $126,393,000.

APPENDIX "E"
STATUTES INVOLVED

47 U.S.C. §152(a):

(a) The provisions of this chapter shall apply to all interstate and foreign communication by wire or radio and all interstate and foreign transmission of energy by radio, which originates and/or is received within the United States, and to all persons engaged within the United States in such communication or such transmission of energy by radio, and to the licensing and regulating of all radio stations as hereinafter provided; but it shall not apply to persons engaged in wire or radio communication or transmission in the Canal Zone, or to wire or radio communication or transmission wholly within the Canal Zone.

47 U.S.C. §153(i), (t):

For the purpose of this chapter, unless the context otherwise requires—

(i) "Person" includes an individual, partnership, association, joint-stock company, trust, or corporation.

(t) "State commission" means the commission, board, or official (by whatever name designated) which under the laws of any State has regulatory jurisdiction with respect to intrastate operations of carriers.

47 U.S.C. §401(b):

(b) If any person fails or neglects to obey any order of the Commission other than for the payment of money, while the same is in effect, the Commission or any

party injured thereby, or the United States, by its Attorney General, may apply to the appropriate district court of the United States for the enforcement of such order. If, after hearing, that court determines that the order was regularly made and duly served, and that the person is in disobedience of the same, the court shall enforce obedience to such order by a writ of injunction or other proper process, mandatory or otherwise, to restrain such person or the officers, agents, or representatives of such person, from further disobedience of such order, or to enjoin upon it or them obedience to the same.

47 U.S.C. §413:

It shall be the duty of every carrier subject to this chapter, within sixty days after the taking effect of this chapter, to designate in writing an agent in the District of Columbia, upon whom service of all notices and process and all orders, decisions, and requirements of the Commission may be made for and on behalf of said carrier in any proceeding or suit pending before the Commission, and to file such designation in the office of the secretary of the Commission, which designation may from time to time be changed by like writing similarly filed; and thereupon service of all notices and process and orders, decisions, and requirements of the Commission may be made upon such carrier by leaving a copy thereof with such designated agent at his office or usual place of residence in the District of Columbia, with like effect as if made personally upon such carrier, and in default of such designation of such agent, service of any notice or other process in any proceeding before said Commission, or of any order, decision, or requirement of the Commission, may be made by posting

such notice, process, order, requirement, or decision in the office of the secretary of the Commission.

47 U.S.C. §416(a):

(a) Every order of the Commission shall be forthwith served upon the designated agent of the carrier in the city of Washington or in such other manner as may be provided by law.